Irving Trust Company A Charter New York Bank
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Economic Research
& Planning Division

Financial Markets

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Interest rates soared this week in reaction to the unexpectedly tough package of monetary policy actions announced by the Federal Reserve last weekend. The 1% increase in the discount rate to 12% was in line with most expectations. While some action in reserve requirements was anticipated, the hike was somewhat surprising, both in magnitude--an incremental 8% on liabilities above a specified base level--and in scope--on a wide group of purchased funds including for the first time Federal funds and repurchase agreements. But the most surprising aspect of the package and the one that caught everyone off guard was the radical shift in the operating tactics employed by the Fed to implement monetary policy. The Fed indicated that it was shifting the emphasis of day-to-day open market activity from the long-prevailing concern with stability of the Federal funds rate to control of reserve expansion.

Thus, the monetary authorities acknowledged the obvious: just how high short-term rates must go to curtail the rapid rate of money and credit expansion is unknown, even to the policymakers. Though short-term interest rates have risen by 300 basis points since the spring, growth in the major monetary and credit measures had accelerated to rates that violate the Fed's target limits for 1979. In this way monetary policy had really been accommodating the rapid growth in credit demand by pumping reserves into the banking system. One measure of reserve availability, for example, the monetary base, accelerated sharply since the spring and, in recent weeks, has been expanding at a 13% annual rate. The shift in operating procedures suggests the Fed will be concentrating more directly on getting reserves into acceptable growth ranges, though the measure of reserves, the growth range, and the operating techniques are so far unknown.

Uncertainty over gauging monetary policy actions in the future plus the likelihood of significantly higher rates left the markets in an obvious state of disarray, and rate movements were dramatic. The Federal funds rate, which ended last week trading in the 11 5/8%-3/4% range, fluctuated anywhere between 10% and 20% this week. Most short-term rates shot up by 1% or more, and banks raised the prime rate an entire percentage point to 14 1/2%. In the bond markets, while an aggressive policy of monetary restraint should improve the longer-run outlook for inflation and ultimately help reduce bond yields, the immediate effect was to further discourage investors from holding bonds, and prices fell abruptly by as much as three points in the taxable and tax-free markets; yields were up as much as 40 basis points. Once again the gloomy market environment led to new records in the government market. This week's 15-year bond offering was auctioned at an average yield of 10.17%, the highest ever on a long-term government bond.

In the foreign exchange markets, the initial reaction to the policy pronouncements was one of wait and see. For one thing there are no explicit dollar support provisions, though progress on cooling U.S. inflation is probably the most important prerequisite for a stronger dollar. More importantly, foreign investors remain skeptical about U.S. resolve in pursuing anti-inflationary policies at home. Failure by U.S. policymakers to follow through on the initiatives of November 1, 1978, and bring money and credit expansion under control is one reason the dollar remains vulnerable today. By week's end, the dollar had begun to strengthen a bit; but over the longer run, the dollar's performance will depend on the Fed's ability to stick with unpleasant policies until they show signs of working.

Glenn C. Picou

Money Market Rates

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	10/12/79 (noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company			
Short-term loans to substantial depositors with highest credit rating	14.50%	13.50%	10.00%
Effective since	10/9/79		
Discount Rate at Federal Reserve Bank	12.00	11.00	8.00
Federal Funds	12.88	11.63	8.75
Repurchase Agreements	12.00	11.00	8.40
U.S. Treasury Issues - Yields			
Bills			
3 months	11.80	11.05	8.05
6 months	12.20	11.30	8.83
1 year	12.40	11.25	8.89
Coupons			
2 years	11.25	10.47	8.69
4 years	10.55	9.83	8.47
7 years	10.35	9.65	8.55
10 years	10.18	9.59	8.58
Long Bond	9.80	9.34	8.62
Negotiable Certificates of Deposit-Secondary Market			
1 month	13.50	12.35	8.85
3 months	13.70	12.55	9.22
6 months	13.90	12.80	9.57
1 year	13.25	12.60	9.58
Bankers' Acceptances			
1 month	13.50	12.00	8.88
3 months	13.90	12.35	9.00
6 months	14.30	12.75	9.20
Eurodollar Deposits			
1 month	14.63	12.56	9.25
2 months	14.81	12.94	9.44
3 months	15.00	13.25	9.81
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	12.75	11.00	8.00
1 month	13.00	11.65	8.80
3 months	12.50	11.00	8.88
Bank Holding Companies			
1 month	13.00	11.75	8.00
Dealer Placed:			
3 months	13.50	11.88	8.83
New Aa Corporate Utility Bond	11.15	10.40	9.25
Tax Exempt			
6 month Project Notes	5.90	5.25	4.20
12 month Project Notes	5.75	5.60	4.60
20 year AAA Bond	6.75	6.20	5.60

This information represents prevailing market yields. It should not be construed as an offering. All yields are on the offered side of the market.

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